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Germany's Return To Reform Politics

Merkel can finally set the conditions for long-term economic growth.

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Germany's electorate has spared the nation the specter of stalemate that loomed over the political horizon for many weeks. The center-right coalition of Christian Democrats and Free Democrats has a clear mandate and, after four years of a grand coalition, politics will return to the more normal cut-and-thrust between the two major ideological camps.

Certainly, the grand coalition didn't fail on all accounts. It managed the financial and economic crisis successfully, and enacted a number of useful economic reforms. Most prominent among these were the introduction of a 25% flat-rate withholding tax on capital income, the gradual lifting of the retirement age to 67 from 65 starting in 2012, and an array of family-friendly measures to promote higher labor participation. But, at the same time, it always reflected the divergent interests of the two big parties involved. Its policies smacked of compromise and there was always the nagging sense that they were not unleashing Germany's full potential. And, on the negative side, the grand coalition jacked up the value-added tax by three percentage points, while failing to exercise the necessary spending restraint in the boom years.

The incoming government will have the opportunity to revitalize the German economy and to use the momentum of change that is inherent in any crisis situation. And action is urgently needed. Investment in the German corporate sector—not particularly high before the crisis began—has now sagged to very subdued levels (equipment investment is set to tumble 20% this year), inadequate to spur growth in the real capital stock. Consumption demand has been weak for many years and housing investment growth is measly. On top of all this, the fiscal budget situation, although better than in many other countries, is growing uglier by the day, with public-sector debt expected to mushroom to almost 80% of gross domestic product next year. If Germany wants to emerge from the crisis stronger than before, obstacles in the path of investment, innovation and entrepreneurship—such as a burdensome bureaucracy, punitive taxation, and deficits in education—must be removed.

Judging by the programs put forward in the election campaign, there will be corrections in private household and corporate taxation. While there is only small room for tax relief given the prevailing budgetary constraints, it is clear that the lower and middle income brackets, which are heavily taxed in Germany with marginal rates of up to 60% (social security plus income tax), need some reduction. The high tax wedge often emphasized by the Organization for Economic Cooperation and Development is a major drag on consumption.

On the corporate taxation front, the incoming coalition partners have shown sympathy for abolishing some newly introduced rules that limit the deductibility of interest payments and thereby add to the tax burden on companies even if their net income is zero or negative. In the field of equity financing there is also some need for action to address lingering distortions in the business tax regime together with the fairly high overall average corporate taxation on profits of just below 30%.

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There is now a chance that this will be corrected. Despite these measures, the net relief for the private sector is likely to be very limited given the immediate budget situation. Any reduction in taxes could well be countervailed by higher social security contributions and possible cuts in tax subsidies or reduced transfer payments as the government strives to keep the lid on rising welfare costs in the wake of the recession. But the issue is not primarily about giving a short-run stimulus. Rather, we need to improve incentive structures that are essential for long-term economic growth. Without a return to stronger growth, the task of budget consolidation will be Herculean.

Another big reform challenge for the new government is health care. The huge health sector is still riddled with inefficiencies and the public insurance set-up results in a steadily rising burden on both wage earners and public budgets. The Free Democrats have voiced far-reaching ideas, involving the privatization of all public health insurance funds and the abolition of the central health fund introduced only this year. The aim is to inject more competition to improve health services and still achieve lower costs. This will not be popular with vested interests in the public health insurance industry and is likely to cause unease in the public-at-large, but it does offer the best way forward.

Regarding labor markets, the national minimum wage favored by the Social Democrats and others can now thankfully be laid to rest, and there will be no revision of previous reforms that added more flexibility in labor relations.

Finally, there is the pending re-regulation of financial markets. The challenge is to tighten the rules on financial markets without excessively undermining activity and exacerbating the funding problems of the corporate sector. Under the new government, the introduction of a financial transaction tax, as demanded by the Social Democrats, now looks unlikely and Germany will not be much more restrictive than its international peers in re-regulating financial markets.

On all these issues the new government will require strong political leadership. Following their devastating defeat, the Social Democratic Party will be vociferous in opposition. But, as the electorate has not staged the big swing to the left that many had feared in the present crisis, the new government would be well-advised, and will hopefully have the confidence, to stick to a clear pro-market concept.

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